

EXHIBIT 2



MULTISTATE TAX COMMISSION

Working Together Since 1967 to Preserve Federalism and Tax Fairness

To: Uniformity Committee, Income and Franchise Tax Subcommittee

From: Sheldon H. Laskin

Date: February 24, 2012

Subject: Status Report, Project Regarding Partnership or Pass-Through Entity Income Ultimately Realized by an Entity That Is Not Subject to Income Tax

The purpose of this memo is to summarize project developments since the subcommittee met in Charleston in November. In November, the subcommittee was considering its proposed course of conduct following the Executive Committee's meeting in July 2011. In June 2011, the Executive Committee had considered approving the model (attached as Exhibit 1) for a bylaw 7 survey and, after receiving significant input from the insurance industry, voted to continue its discussion to its July 28, 2011 meeting. At that meeting, representatives from the insurance industry suggested again that they had concerns with the current model, had proposals that would address the committee's concerns in a less intrusive way, and that they would be willing to work with the uniformity committee to develop those alternatives. The Executive Committee voted to ask the Uniformity Committee to work with the insurance industry on developing those alternatives and then to provide a matrix summarizing the various tax problems that arise when income taxpayers and non-income taxpayers are part of the same affiliated group and the possible solutions – existing as well as proposed models – for addressing those problems. During the subcommittee's November meeting, Dan Schelp, managing counsel of the National Association of Insurance Commissioners (NAIC), appeared and outlined the basics of insurance industry taxation and regulation by state insurance commissions. The subcommittee asked Mr. Schelp a series of questions regarding retaliatory tax and its relevance, if any, to the current proposal, as well as issues of insurance company capitalization and overcapitalization. Mr. Schelp offered NAIC's technical assistance in developing rules. The subcommittee asked that the

drafting group be reconvened and that it work with industry and regulators to develop the information necessary for the subcommittee to respond to the Executive Committee.¹

Since November, the drafting group has met twice with industry and regulatory representatives.² At the first meeting on January 17, 2012, industry presented an overview of state taxation of insurance and stated its view that the model is both unnecessary and not responsive to the unique tax nature of the industry. As to the first point, industry expressed the view that any concerns regarding abusive tax practices could be addressed by limiting the proposal to captive insurance companies.³ In fact, the Commission has previously addressed issues of asset stuffing and income shifting to passive insurance companies by recommending that such companies be combined with non-insurance affiliates, in combined reporting states.

As to the second issue, the industry representatives noted that the “in lieu of” premium tax that insurers are subject to in every state consistently raises more revenue than would a net income tax.

Industry’s assertion is based on the experience of several states that impose a “higher of” tax regime on insurers, under which insurers are to pay the higher of the premium tax or the net income tax. It should be noted that the proposal would not impose an income tax on insurers. Instead, the proposal would impose income tax on the pass-through’s income. This income is ordinarily subject to income tax when it is passed through to taxable entities. The tax equity issue the proposal is designed to address arises from the fact that the income is never subject to tax if it is passed through to an entity that is not itself subject to tax. The purpose of providing the exclusion for pass-through entities was to assure that that income would only be subject to tax once, not that it would never be subject to tax. It is the view of the drafting group that the fact that insurance companies are subject to a different tax regime than taxable entities does not address the underlying tax equity issue – pass-through income is differentially subject to tax depending on whether or not the parent is subject to tax, contrary to the purpose of creating pass-throughs to begin with.

¹ The drafting group currently consists of Michael Fatale of Massachusetts, Phil Horowitz of Colorado, Brenda Gilmer of Montana and Frank O’Connell of Georgia.

² Those representatives include Mr. Schelp, Steve Johnson from the Pennsylvania Department of Insurance, Bob Montellione of Prudential, Frank Alberts of Firemen’s Fund, Jim Hall of ACLI, Josie Lowman of AIG and Jim Williams of Mass Mutual.

³ At its meeting of October 7, 2009, the subcommittee directed the drafting group to prepare a proposed draft statute addressing the tax equity issue raised by pass-through entities generating income that is passed through to non-taxable entities such as insurance companies. The current model is the result of that directive. At its October 2009 meeting, the subcommittee also directed the drafting group to continue to work on overcapitalization and captive insurance issues following the completion of the current phase of the project to address the pass-through issue.

Finally, the representatives continued to express concerns that subjecting pass-through income to tax could subject the insurers to retaliatory tax. The drafting group questioned why this would be the case, noting that corporate affiliates of insurance companies are currently subject to state income tax, apparently without resulting in any adverse retaliatory tax cases.

Following the January 17 teleconference, industry provided the drafting group with organizational charts for a number of leading insurance companies. Mr. Fatale has conducted an analysis of the charts to trace the development of LLCs and other pass-through entities owned by insurance companies over the past 20 years. He presented a summary of his analysis at the second teleconference held with industry representatives on February 10, 2012. Those charts show that the business structure of insurance companies over that time frame has reflected the general business tendency to structure its lower-level entities in pass-through form.⁴ Some examples from Mr. Fatale's research illustrate the growth of non-insurance lower-level LLCs whose assets are under management by insurance parents.

1. John Hancock Life Insurance Company. In 1999, John Hancock's SEC-filed organization group showed the John Hancock affiliated group owned no LLCs, while it did own two corporations. By 2011, the SEC-filed organization charts showed at least five non-insurance LLCs owned either directly or through one or more other LLCs by John Hancock. According to "Find the Best", the Internet listing for one of these LLCs – Management, LLC— currently manages two hundred accounts totaling an estimated \$117,290,206,047 of assets under management.⁵
2. Hartford Life Insurance Company. In 1998, Hartford's SEC-filed organizational chart shows the Hartford group owning no LLCs. Several LLCs appeared on the chart the following year. By 2010, the number of LLCs owned by or owning other LLCs in the Hartford group had grown to at least six. One – RVR LLC – was formed on April 29, 2009 to take title to and manage real property. According to "Find the Best", Investment Services, LLC manages 55 accounts totaling an estimated \$59,397,017,574 of assets under management and HL Advisors manages 33 accounts totaling an estimated \$45,029,570,030 of assets under management.
3. Pennsylvania Mutual Life Insurance Company. Janney Montgomery, a Philadelphia-based regional retail brokerage, was acquired by Penn Mutual in 1982. It was converted

⁴ According to a recent article in the Wall Street Journal, "the percentage of U.S. corporations organized as nontaxable businesses has grown from about 24% in 1986 to about 69% as of 2008.... The percentage of all firms is far higher when partnerships and sole proprietors are included. By some estimates, more than 60% of U.S. businesses with profits of \$1 million are structured as pass-throughs, the highest rate among developed countries...." *More Firms Enjoy Tax-Free Status*, by John D. McKinnon (WSJ, January 10, 2012).

⁵ Documentation for all these examples is contained in the .pdf binder that is submitted with this memo. At this time, I am only providing a high-level summary of this material. As explained in the text, industry has requested more time to submit a position paper in support of its view that the proposal should not be adopted. That paper is to be submitted by the end of March. Following the submission of that report, I will prepare a more detailed analysis of both the states' position and that of industry.

to an LLC in 1999. According to “Find the Best”, it currently has \$8,918,685,956 of assets under management.

The magnitude of the assets involved in these examples illustrate the central question presented by use of a pass-through structure when the corporate parent is itself not subject to tax – was it ever contemplated that use of a pass-through structure would result in creating a class of pass-through entities whose income would be nontaxable at any level, merely because the parent is itself not subject to tax? In the specific context of insurance, was it ever contemplated that the “in lieu of” premium tax would shield income of this magnitude from taxation at the pass-through level?

Following the February 10th teleconference, industry offered to provide a response to the subcommittee’s request for an additional analysis of potential retaliatory tax implications of the model. In addition, industry will address why it believes that any discussion of equity must be addressed in the broader context of the unique aspects of state taxation and regulation of the insurance industry, and how the industry believes it significantly differs from all other non-insurance industries. Lastly, industry will provide model language aimed at addressing what it believes should be the focus of this project; the abusive use of an insurance company to evade taxes.⁶ Because it is currently premium tax filing season, industry was unable to provide this information at this time and has indicated it will do so as of the end of March.

⁶ Industry acknowledges that the Executive Committee requested it provide proposed model language at its July 1011 meeting.